

November 15, 2002

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STATE LEGISLATIVE UPDATE

Legislative Analyst's Projections of California's Fiscal Outlook

The Legislative Analyst's Office (LAO) issued its annual forecast of the State's outlook from FY 2002-03 through FY 2007-08. The findings and conclusions of the report, which is based upon detailed analysis/projections of the State's economy and demographic trends, revenue collections and expenditures, provide an independent assessment of the State's fiscal outlook to assist the Legislature in adopting a budget for FY 2003-04. The LAO's report (which is available at www.lao.ca.gov) provides the details of their projections. However, this report focuses on the implications for the State budget.

The Budget Problem

As anticipated, the State once again faces a major budget deficit. However, the magnitude of the deficit is far greater - more than double - what had been projected just three months ago when the Legislature adopted the current budget. The LAO now projects that next year's deficit will total \$21.1 billion - a \$6.1 billion deficit from the current budget and a \$15 billion gap between expenditures and revenues in the budget year. While the size of the budget problem is actually less than last year, according to the LAO:

“The current budget shortfall is much more formidable and challenging than last year's. This is due both to the magnitude of the problem and because a number of the one-time solutions heavily relied on last year cannot be used again....Given this, there is really no easy way out of the current predicament....”

Looking beyond the budget year, the LAO projects continuing operating deficits in the range of \$12 billion to \$16 billion annually through FY 2007-08 -- some 14 percent of the General Fund budget - unless permanent, corrective actions are taken. Even this gloomy outlook is premised on a return to a healthy rate of economic growth in FY 2004. In short, the State is not likely to be able to "grow" itself out of its budget problems and could face an even larger problem if the anticipated growth in business spending and hiring occurs later than anticipated or if consumer spending, which has sustained the economy during the current downturn, suddenly declines.

According to the LAO, roughly one-half of the projected shortfall is a result of persistent softness in the economy that is causing State revenues, especially the personal income tax, to lag substantially below what had been projected in earlier forecasts. In fact, revenues in the current year would actually decline 1 percent, were it not for the various one-time tax increases, loans and transfers included in the budget. While revenues in the budget year are up 5.6 percent (not including the impact from the loss of one-time revenues), the underlying problem is that whatever the level of growth, it is from a much smaller revenue base.

The other half of the shortfall is attributed by the LAO to an ongoing structural imbalance in the State budget between revenues and expenditures. The current budget, which was "balanced" through roughly \$10 billion in one-time revenues, loans and transfers, only postponed the real problem and in some ways made it worse. It is the primary reason that unless corrective action is taken, the LAO projects continuing operating budgets through FY 2007-08. In the budget year, General Fund revenues will decline from \$75 billion to \$70 billion (due to the loss of one-time revenues) while expenditures will increase from \$78.5 billion to \$85.2 billion. The result is an operating deficit of \$15 billion, which together with the \$6.1 billion deficit from the current year, comprise the \$21.1 billion shortfall.

The \$6.1 billion current year deficit has four elements: a \$410 million smaller balance from prior years; a \$4.9 billion reduction in revenues for FY 2001-02 and FY 2002-03; \$1.8 billion in excess spending, and the \$1 billion reserve. The excess spending includes downward adjustments in some of the optimistic savings assumptions relied upon to balance the budget, including a 10 percent reduction in state department operations, implementation of a golden handshake program, elimination of vacant positions, and continuation of a hiring freeze. These items, which were expected to save over \$1.1 billion, will save around \$300 million in FY 2002-03. In addition, \$400 million of assumed Federal Assistance to offset the increase in the State's matching rate for Medicaid has not been taken up by Congress. The other major action that is not producing the anticipated savings is enhanced MediCal fraud detection.

The Assumptions

The LAO's revenue and expenditure forecasts are based upon the requirements of current law, adjusted for changes in caseloads, cost-of-living adjustments, federal reimbursements and other cost factors such as employee compensation. Of particular importance to counties, the expenditure projection assumes that prior year SB 90 claims will be paid, including the \$800 million of non-education payments deferred as part of the current year's budget solution. In addition, for purposes of calculating the State's cost for the Proposition 98 guarantee, the forecast assumes an average annual growth in local property taxes of 7.5 percent. Finally, the estimates assume the repayment of all one-time loans to the General Fund by special funds according to the schedule in the adopted budget.

Projected Spending Trends

Given the fact that one of the major goals for the next State budget will be to reduce the rate of expenditures, an examination of the average annual growth rate for major State programs may suggest the most likely areas for reductions. Through FY 2007-08 the LAO is projecting an average annual growth rate for the General Fund of 6.6 percent. By comparison, their projections for other areas include:

- K-12 Proposition 98 - 4.3%
- Higher Education - 5.4%
- Medi-Cal - 8.8%
- CalWORKs - no growth
- SSI/SSP - 6.4%
- IHSS - 9 %
- Other Major Health and Social Services - 6.5%
- Department of Corrections - 4.5%
- VLF Subventions - 5 %
- Debt Service - 16.8%
- Other Programs/Costs (including Proposition 42 diversion of sales taxes on gasoline to transportation), employee compensation, and SB 90 - 12.2%

"Approaching the Problem"

Unless requested, the LAO avoids making specific recommendations on how to solve the budget problem. However, as it did last year, it suggests for consideration a set of "budget balancing principles, strategies, and tools" for the Legislature's consideration, including some generic spending and revenue-related options. Singled out for special consideration are three important suggestions: to take action to reduce current year spending as was

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done in mid-year for the FY 2001-02 budget; in considering options, “nothing should be taken off the table”, including K-12 education or revenue increases; and while one-time solutions can be a critical part of the budget solution (up to the tune of roughly \$6 billion to offset the FY 2002-03 deficit), “major ongoing solutions” must be adopted to address the remaining \$15 billion budget gap.

Initial Reactions

Since the report was only released this morning (key legislators were briefed yesterday), initial reaction to the LAO report is limited. According to newspaper accounts, the Governor’s staff indicated that they are working on cuts and that departments are about to submit plans to reduce their spending by 20 percent. Democratic legislators have said the problem is so big that new revenues, as well as expenditure reductions, will have to be considered. Also, the Republican Vice-Chairman of the Assembly Budget Committee, John Campbell, is said to have already rejected any tax increases.

New Legislative Session

The Legislature will convene on December 2, 2002. This is traditionally a time reserved for selecting leadership and announcing committee assignments. The Governor is scheduled to submit his Budget no later than January 10, 2003.

We will continue to keep you advised.

DEJ:GK
MAL:JR:ib

c: Executive Officer, Board of Supervisors
 County Counsel
 All Department Heads
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